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In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 71-

UNITED STATES OF AMERICA, PETITIONER

v.

JAMES A. BASYE AND EVELYN E. BASYE, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgments of the United States Court of Appeals for the Ninth Circuit in these six cases, which were consolidated in the courts below and present the identical question.[1]

OPINIONS BELOW

The opinion of the district court (Appendix A, *infra*, pp. 15–29) is reported at 295 F. Supp. 1289. The opinion of the court of appeals (Appendix B, *infra*,, pp. 31–42, including an order amending the opinion) is reported at 450 F. 2d 109.

[1] The cases are combined in this petition pursuant to Rule 23(5) of the Rules of this Court. See *United States* v. *Mitchell*, 403 U.S. 190, 194.

JURISDICTION

The judgments of the court of appeals were entered on September 16, 1971 (Appendix C, *infra*, pp. 43–48). By order dated December 10, 1971, Mr. Justice Douglas extended the time for filing a petition for a writ of certiorari to and including February 12, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether compensation for services rendered by a medical partnership, and made payable by contract, and paid, to a trust, is income of the partnership, and therefore taxable to the partners, as the United States contends, or whether, as the courts below held, such compensation is not partnership income and will constitute income to beneficiaries of the trust, only when distributed to them.

STATUTES INVOLVED

The pertinent provisions of Sections 61, 401, 404, 701, 702, 703 and 704 of the Internal Revenue Code of 1954, are set forth in Appendix D, *infra*, pp. 49–51.

STATEMENT

Respondents are physicians and partners[2] in a

[2] "Respondents" refers collectively to James A. Basye, Carol L. Cook, Maurice C. Fishler, Henry Donald Grant, William S. Hunter, Jessamine S. Hunter, and Nadia Sorokowski, each of whom was a physician and partner during the years involved. Evelyn E. Basye, Jack J. Cook, Phyllis H. Fishler, Jean M. Grant, and George W. Sorokowski are parties to these actions only because they filed joint income tax returns with their respective spouses, and, in the case of Jean M. Grant for the year 1960, because she reported one-half of the community income in a separate return.

medical partnership, Permanente Medical Group ("Medical Group"), which was organized in 1949 to practice medicine in California. The partnership reports its income on the accrual basis. In 1960, it had over 200 physician-partners and 41 physician-employees. Under the partnership agreement, the partners had drawing accounts varying with responsibility and seniority, but were to share equally in net earnings in excess of the drawing accounts. (Appendix B, *infra*, pp. 31–32.)

In 1959, Medical Group entered into a detailed written agreement with Kaiser Foundation Health Plan, Inc. ("Health Plan"), an organization supplying prepaid medical care and hospital service to its members. Under the agreement, Medical Group agreed to furnish medical services to Health Plan's members in its Northern California Region, of whom there were then approximately 359,000. On its part, Health Plan agreed to make payments, as base compensation[1] to Medical Group for medical services, in two forms: (a) to pay Medical Group a stated amount (originally $2.61329, subject to adjustment) per month, per member, and (b) if Medical Group established a savings and retirement, or other deferred compensation, plan approved by Health Plan, to make the contributions required under that plan. (Appendix B, *infra*, p. 32.)

The plan in question was agreed upon and established by a trust agreement executed by Medical

[1] A provision for contingent additional compensation is not relevant to the issues in these cases.

Group, Health Plan, and a bank later in 1959, but effective from the date of the agreement. Under it, Health Plan made a payment of $200,000 to the trust at the outset, and agreed to make further payments on a per member, per month basis. The funds of the trust were to be used to pay retirement benefits to partners and physician-employees of Medical Group, computed on a complex of factors such as age, years of service, and compensation level. Tentative allocations of funds received were made under the plan, but were not vested prior to retirement, and might be lost prior to, or after, retirement by withdrawal from Medical Group for practice other than with another group serving Health Plan's members. The primary purpose of this feature of the agreement was to create an incentive for physicians to remain with Medical Group, and thus to insure Health Plan that it would have a stable and reliable group of physicians providing medical services to its members with a minimum of turnover. The trust was subject to amendment at any time by Health Plan and Medical Group. (Appendix B, *infra*, pp. 32–33).

Over a 3½-year period, Health Plan paid into the trust, on a monthly basis, an aggregate of more than $2 million. Medical Group did not include these payments in its partnership returns of taxable income, and they were not included in the partners' distributive shares of gross or taxable income. The Commissioner of Internal Revenue assessed deficiencies against the respondent partners for 1960

and 1961 on the ground that the compensation paid to the trust constituted gross income to the partnership, deflected to the trust through the contractual arrangement with Health Plan; and, therefore, that the partners were taxable on their distributive shares of such income. Respondents paid the taxes in dispute and, after their claims for refunds were denied, brought these suits for refund. (Appendix B, *infra*, p. 34.)

Both courts below held that the partnership realized no gross income from the payments because it never had a right to receive them, and further held that the partnership should be considered merely the agent of the partners, and should otherwise be disregarded in determining their tax liabilities. Treating the partners merely as contingent trust beneficiaries, the lower courts concluded that they would be taxable on payments to the trust only at such time as distributions were made by the trust. (Appendix A, *infra*, pp. 15–29; Appendix B, *infra*, pp. 31–42.)

REASONS FOR GRANTING THE WRIT

1. The decision below is in conflict with the holding in one of this Court's fundamental income tax decisions, *Lucas* v. *Earl*, 281 U.S. 111, a decision that is a principal bulwark of the graduated rate structure, and that this Court has subsequently described as embodying "the first principle of income taxation: that income must be taxed to him who earns it." *Commissioner* v. *Culbertson*, 337 U.S. 733, 739–740. The decision below is equally in conflict with

numerous decisions of courts of appeals following and applying *Lucas* v. *Earl*.[4]

When the court below permitted payments explicitly made as compensation for partnership services to be excluded from partnership income because of a contractual arrangement to deflect those payments to a trust, it acted in complete disregard of the historic statement of this Court that established "the first principle" of income taxation (281 U.S. at 114–115):

> There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

The court below thought that *Lucas* v. *Earl* was not controlling because (Appendix B, *infra*, p. 39) "a crucial element * * * is missing here. Permanente never

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[4] *Allen* v *Commissioner*, 410 F. 2d 398 (C.A. 3), affirming 50 T.C. 466; *Hicks* v. *United States*, 314 F. 2d 180 (C.A. 4); *Megibow* v. *Commissioner*, 218 F. 2d 687 (C.A. 3); *Mayes* v. *United States*, 207 F. 2d 326 (C.A. 10); *Miller* v. *Commissioner*, 144 F. 2d 287 (C.A. 4); *Villere* v. *Commissioner*, 133 F. 2d 905 (C.A. 5); *Hogle* v. *Commissioner*, 132 F. 2d 66 (C.A. 10); *Comer* v. *Davis*, 107 F. 2d 355 (C.A. 5); *Jones* v. *Page*, 102 F. 2d 144 (C.A. 5); *Commissioner* v. *Bonwit*, 87 F. 2d 764 (C.A. 2), certiorari denied, 302 U.S. 694; *Canaday* v. *Guitteau*, 86 F. 2d 303 (C.A. 6); *Saenger* v. *Commissioner*, 69 F. 2d 631 (C.A. 5).

had the right itself to receive the payments made into the trust as current income." But much the same point was made by the same court when *Lucas* v. *Earl* was originally before it. See *Earl* v. *Commissioner*, 30 F. 2d 898, 899 (C.A. 9). In any event, the distinction is nonexistent. Since Mr. Earl had assigned half his income to his wife beginning in 1901, and *Lucas* v. *Earl* involved fees and salary earned in 1920 and 1921, he, also, "never had the right * * * to receive the payments." The same was true in the case of *United States* v. *Joliet & Chicago R. Co.*, 315 U.S. 44, and in the numerous courts of appeals cases following and applying *Lucas* v. *Earl*. See cases cited in note 4, *supra*. In all of these cases, the deflected income was held taxable to the person who earned it. Indeed, *Lucas* v. *Earl* would be no more than an empty admonition if a contractual arrangement to insulate a taxpayer from receipt of compensation he earned could serve to immunize him from taxation. And this Court's decision in *Helvering* v. *Eubank*, 311 U.S. 122, makes it clear that an attempted deflection of earned income is ineffective to avoid tax liability whether the deflecting arrangement is made before the income is earned, as in *Lucas* v. *Earl*, or after, as in *Helvering* v. *Eubank*.[5]

[5] The court of appeals' quotation (Appendix B, *infra*, p. 38) from *Helvering* v. *Horst*, 311 U.S. 112, with respect to "the diversion of income theory" is not entirely apposite. While *Horst* is, of course, a leading decision on the deflection of income, it dealt with the deflection of income from property, rather than from services. As pointed out in *Commissioner* v. *Sunnen*, 333 U.S. 591, taxation of deflected income from property turns upon ownership or control of the income-producing property, or control of the flow of income, while "[c]ompensa-

Nor does it alter the result that Health Plan's purposes were served by virtue of the deflection of partnership compensation to a trust. See *Commissioner* v. *LoBue*, 351 U.S. 243, 247; Section 61 of the Internal Revenue Code of 1954, Appendix D, *infra*, p. 49. Increased compensation paid with a view to reducing turnover and increasing stability in employment is not for that reason any the less taxable income. *Bingler* v. *Johnson*, 394 U.S. 741. As the Court explained in *Lucas* v. *Earl* (281 U.S. at 115), "the motives leading to the arrangement" permit no distinction. And though the agreement involved here is hardly consistent with the Ninth Circuit's conclusion (Appendix B, *infra*, p. 40) that "[t]he payments are to be viewed not as compensation for immediately past medical services but as compensation for the continued, long-term services of individual physicians," the payments to the trust would be includable in the partnership's income even if

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tion for personal services performed by the taxpayer is an inherently non-assignable gross income item." Lyon & Eustice, *Assignment of Income*, 17 Tax L. Rev. 295, 388 (1962). For a case in which decision turned upon whether the deflected income was from property or from services, see *Strauss* v. *Commissioner*, 168 F. 2d 441 (C.A. 2), certiorari denied, 335 U.S. 858, rehearing denied, 335 U.S. 888. However, even by *Horst* standards, there would be a basis for attributing to Medical Group the income paid to the trust, since the trust was subject to amendment by Medical Group and Health Plan, and, by statutory definition (Section 672 (a) and (b)), Health Plan was a nonadverse party. Under Sections 676 and 677 of the Code, a trust grantor may be taxed on trust income where, together with a nonadverse party, it has discretion (whether exercisable through amendment of the trust instrument or otherwise) to distribute trust income or principal to itself.

they were for future services. *Schlude* v. *Commissioner*, 372 U.S. 128; *Bingler* v. *Johnson*.

Because *Lucas* v. *Earl* is a cornerstone in the structure of the income tax law, no decision that impairs its integrity should be permitted to stand. The decision below does precisely this, and, for this reason alone, should be reviewed by this Court.

2. The decision below is in conflict also with the holding in a basic decision of this Court on the taxation of partnership income, *Heiner* v. *Mellon*, 304 U.S. 271, and with numerous decisions in the courts of appeals following and applying that decision.*

Since the enactment of Section II, D, of the Income Tax Act of 1913, c. 16, 38 Stat. 166, the federal statutes taxing income have treated partnership income in the manner that, in somewhat greater detail, is now set forth in Sections 701 through 704 of the Internal Revenue Code of 1954 (Appendix D, *infra*, p. 51): the partnership itself is not taxed, but it prepares and files a return in much the same manner that is required of an individual taxpayer, and the partners are required to take into income their distributive shares of partnership income. In *Heiner* v. *Mellon*, this Court held that distributive did not mean

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* *Starr* v. *Commissioner*, 267 F. 2d 148 (C.A. 7); *United States* v. *Baker*, 233 F. 2d 195 (C.A. 10); *Hulbert* v. *Commissioner*, 227 F. 2d 399 (C.A. 7); *Bell* v. *Commissioner*, 219 F. 2d 442 (C.A. 5); *Commissioner* v. *Goldberger's Estate*, 215 F. 2d 78 C.A. 3); *First Mechanics Bank* v. *Commissioner*, 91 F. 2d 275 (C.A. 3); *Bourne* v. *Commissioner*, 62 F. 2d 648 (C.A. 4), certiorari denied, 290 U.S. 650; see also *Beck Chemical Equipment Corp.* v. *Commissioner*, 27 T.C. 840; *deCousser* v. *Commissioner*, 16 T.C. 65; *Halkias* v. *Commissioner*, 12 T.C. 1091; *Freudmann* v. *Commissioner*, 10 T.C. 775.

distributable, and that partners are required to take into their individual income their distributive, or proportionate, shares of partnership income even though applicable state law prevents distribution. *A fortiori*, partners are required to take into their individual income their distributive shares of partnership income even though contractual or other consensual arrangements prevent distribution. See cases cited in note 6, *supra*.

It thus necessarily follows from the fact that Health Plan's payments to the trust constitute gross income to the partnership (see point 1, *supra*) that the respondent partners must take into their income their distributive shares of the partnership income despite any contractual arrangement, by trust or otherwise, to hold distribution in abeyance. Contrary to the court of appeals' understanding (Appendix B, *infra*, pp. 37, 41), the government's position that the payments constitute partnership gross income, and in consequence, gross income to the partners, does not turn on whether one follows the "entity" or "conduit" theory of partnerships. Those concepts can come into play only where there is a question of characterizing income, and there is, of course, no question that compensation for services is ordinary income to a partnership and to a partner. See Sections 61 and 702(a)(9). Under any theory of partnerships, therefore, the distributive shares of partnership income must be included in the income of the individual partners for the simple reason that the partnership earned the income. In disregarding this fact, in viewing the respondent partners only as contingent beneficiaries of the trust,

and in treating the partnership only as an agent to arrange contingent future compensation for the partners and physician-employees, the court of appeals erred. The Internal Revenue Code would command the result for which we contend here with respect to the partnership and the partners whether all, or only some, of the partners were potential beneficiaries of the trust, or whether the potential beneficiaries were children or other relatives of the partners.

Likewise mistaken is the court of appeals' conclusion (Appendix B, *infra*, p. 36) that had respondents "contracted individually with * * * [Health Plan] for payments into a retirement trust subject to the same conditions involved here, they would not be subject to taxation in the years the payments were made." Under *Lucas* v. *Earl*, an individual physician (or, for that matter, a corporation) contracting with Health Plan, with similar provisions for payments to a trust for himself and his employees, or for others, would be taxed currently on amounts irrevocably paid to the trust because, as to him, such payments would be no more than deflected compensation for services rendered. The cases upon which the court below relied (see Appendix B, *infra*, p. 36) would be relevant, irrespective of whether an individual, a corporation, or a partnership contracted with Health Plan, only if the government asserted deficiencies against the employee-beneficiaries of the trust who might never be compensated for their services. They are of no relevance where, as here, the contracting party (the partnership) was irrevocably compensated by the bargained-for payments to the trust, and we are concerned only

with the tax liabilities of the individual partners therefor.

3. The decision below effectively circumvents the limitations upon qualified pension trusts established by Section 401 of the Internal Revenue Code of 1954, Appendix D, *infra*, pp. 49–50.

Section 401, as effective during the years in controversy, establishes for qualified pension trusts the terms upon which the Congress has sanctioned deferred compensation plans with the tax benefits of current deductibility to the employer and deferred taxation of the employee. Among other conditions, such a trust must be "for the exclusive benefit of * * * employees or their beneficiaries." Section 401 (a). Moreover, such a trust must not discriminate in favor of officers, supervisory employees, or highly compensated employees. Section 401(a)(4). Because of these conditions, there could be no qualified pension trust for the benefit of self-employed individuals, whether partners or sole proprietors, during 1960 and 1961. Though that restriction has been relaxed somewhat in later years by amendments to the Code effected by the Self-Employed Individuals Tax Retirement Act of 1962, P.L. 87–792, 76 Stat. 809, the conditions imposed even under the relaxed provisions remain rigorous, both as to discrimination in favor of highly compensated individuals, and as to amounts that may be contributed to a pension trust for the benefit of partners rather than employees.

The trust here involved, which was principally for the benefit of partners, and otherwise provided benefits only for professional physician-em-

ployees, could not qualify under either the standards of 1960 and 1961 or those of later years. Yet, in frustration of the statutory limitations on qualified pension trusts, the decision below produces for the partnership and the partners the principal tax benefits of such a trust, and thus openly invites partnerships to circumvent the requirements carefully devised by Congress as conditions to obtaining these benefits.[7] Under the decision, there is nothing to prevent partnerships, large and small, and in any business or profession, from establishing similar plans to avoid tax on whatever portion of their compensation they choose to defer.

4. Apart from the mischief the decision below is certain to cause within the Ninth Circuit, and may cause elsewhere, the instant cases are of immediate administrative importance. We are advised by the Internal Revenue Service that the cases of 568 taxpayers (many involving several taxable years) in California and Oregon are being held open pending final disposition of the instant cases. The tax deficiencies in the open cases aggregate more than $1.6 million, and the statutory interest on these deficiencies, which relate to 1962 and earlier years, brings the total amount in dispute to approximately $2.5 million.

[7] If the trust had constituted a pension trust for employees qualified under Section 401, the payments to the trust by Health Plan would still have constituted gross income to the Medical Group partnership but would, at the same time, have given rise to an offsetting deduction by Medical Group. However, since on several grounds, including the fact that it was principally for the benefit of partners, the trust was not a qualified pension trust under Section 401, the offsetting deduction would be denied by Section 404, Appendix D, *infra*, p. 50.

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CONCLUSION

The court below has on two scores unsettled what was settled by this Court more than thirty years ago. Review and correction is therefore appropriate.

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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FEBRUARY 1972.

APPENDIX A

In the United States District Court for the Northern District of California

Consolidated Actions

Civil No. 44352

JAMES A. BASYE AND EVELYN E. BASYE, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

Civil No. 44353

JACK J. COOK AND CAROL L. COOK, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

Civil No. 44354

MAURICE C. FISHLER AND PHYLLIS H. FISHLER, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

Civil No. 44355

HENRY DONALD GRANT AND JEAN H. GRANT, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

Civil No. 44356

WILLIAM S. HUNTER AND JESSAMINE S. HUNTER, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

Civil No. 45575

GEORGE W. SOROKOWSKI AND NADIA SOROKOWSKI, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

Memorandum and Order Directing Judgment for Plaintiffs

These are consolidated actions for the refund of income taxes, and each one poses the identical problem which arises within the partnership provisions of the Internal Revenue Code. The facts have been stipulated to by the taxpayer petitioners and the respondent Commissioner of Internal Revenue. The petitioners are physicians who were each, during the years involved in their respective cases, general partners in a limited partnership of physicians organized in 1949 to practice medicine in California under the name of "The Permanente Medical Group" (hereinafter referred to as Permanente or as the partnership). This partnership used the accrual method of tax accounting in filing its partnership information returns. All partners used the cash method of accounting.

Prior to the years involved in these cases, Permanente contracted with Kaiser Foundation Health Plan, Inc. (hereafter referred to as Kaiser), a California nonprofit corporation, to provide medical services to members of Kaiser in its Northern California Region. Kaiser operates a contractual membership program providing pre-paid hospital and medical care to its dues paying members. The contract provided that Kaiser would not only pay a basic compensation to Permanente for the medical services, but would also make payments toward a retirement plan when such a plan was approved by Kaiser. On or about December 30, 1958, such a plan (hereafter referred to as the Retirement Plan) was established to take effect as of July 1, 1959, by a trust agreement among Kaiser, Permanente, and the Bank of America National Trust and Savings Association, as trustee. In entering into both the original medical services contract and the trust agreement, Permanente and Kaiser were and remained independent organizations contracting at arms length.

The primary purpose of the trust agreement and the retirement plan is to create an incentive for physicians to remain with Permanente, or if they left Permanente, then to join some other group of physicians contracting to serve Kaiser members, thereby ensuring Kaiser that it would have a stable and reliable pool of physicians providing medical services to its members. To secure this purpose, the Retirement Plan contains the following provisions. A trust fund under the Bank of America trusteeship was established, and is to be supported by payments from Kaiser in partial compensation for the services of Permanente. Each physician who had served two years within Permanente, both those who were partners and those who were merely employees, was assigned a certain number of "units", which took into account such factors as the physician's salary from Permanente, his past service with Permanente, and the age at which he became associated with Permanente. Tentative accounts were then set up for each physician, and these accounts were credited with portions of the trust fund earnings (which included payments from Kaiser plus interest accrued on the corpus), with each account receiving credits in proportion to the units assigned to that particular physician. The accounts are tentative because the eventual enjoyment by any physician of his accrued share of the fund depends on several contingencies. If either a partner-participant or an employee-participant in the Retirement Plan terminates his affiliation with Permanente, for reasons other than his death or disability, prior to reaching age 65 or serving Permanente for fifteen continuous years, and if the participant does not thereupon join another medical group serving Kaiser subscribers, he forfeits the amounts allocated to his tentative account. And even upon his becoming eligible to receive retire-

ment benefits from his tentative account, a participant may lose his right to these benefits if he renders professional services for a competitor of Kaiser, or if, while he is physically fit and legally entitled to practice medicine, he refuses to render consulting services to any medical group under contract with Kaiser, when reasonably requested to do so. Moreover, a "Retirement Committee", composed of representatives selected by both Kaiser and Permanente, is given the power to prescribe further conditions to the receipt of Retirement Plan benefits by participants.

The effect on each participant's rights in the trust fund in the event of a dissolution or reorganization of Permanente is of particular interest in the present case. The trust agreement provides that if, in the event of a dissolution or reorganization of Permanente, at least 50% of the combined total of practicing partner-participants and employee-participants become reassociated with a reorganized Permanente or with another group serving Kaiser subscribers, then the trust fund shall be kept intact and any unretired physician-participant who does not join in the new grouping shall forfeit his rights in the trust fund. The forfeiture will not occur in either of two circumstances. First, if in connection with Permanente's dissolution or reorganization, Kaiser and Permanente jointly agree to use the trust funds to support a new retirement plan which they believe will provide better retirement benefits for the participants, or will better effect the original purpose of the trust agreement (viz., a reliable pool of doctors for Kaiser), then such a new retirement plan could provide that the accruals in the tentative accounts of all participants would be preserved. Second, if there is a dissolution or reorganization of Permanente without the above-mentioned 50% regrouping and without the creation of a new

retirement plan by Permanente and Kaiser, then the assets held by the trust fund are to be liquidated and the proceeds distributed to all participants, retired and active, in lump sums prorated according to the tentative account balances.

The Commissioner of Internal Revenue determined that the partnership income returns filed by Permanente for its fiscal years ending June 30, 1960 through 1963 had understated income in omitting the sums of Kaiser's payments to the trust fund and the earnings on trust corpus. The Commissioner further determined that the increased partnership income was taxable to the partners for each calendar year in which the partnership fiscal year ended, and he assessed deficiencies in the individual income tax returns of each of the partners, including plaintiffs. In computing the deficiency for each partner, the Commissioner used the following formula. He calculated the total sum of payments attributable to the tentative accounts of *employee*-participants in the Retirement Plan, and he assessed each partner for these payments according to that partner's distributive share of general partnership income under the partnership articles.[1] He further assessed each partner for the annual increments in trust earnings attributable to that partner's own tentative account in the Retirement Plan, thereby treating the "unit" allocations under the trust agreement as a modification of the basic partnership agreement on the distribution of partnership earnings.[2]

[1] See Int. Rev. Code of 1954, § 704(b). The theory underlying this aspect of the assessment was probably that Health Plan by funding the retirement plan for the employee-physicians was saving Permanente from incurring the expense for such a project, and was therefore in effect supplying Permanente with additional income.

[2] See Int. Rev. Code of 1954, § 704(a), and Reg. 1.761-(c).

It is this latter assessment which is contested here. Plaintiffs do not contend that they should never be taxed on the allocations to their tentative accounts, but rather that, in view of the many contingencies which condition their actual receipt of the proceeds represented in their accounts, the tax should be postponed until such actual receipt. The government prefers to tax the plaintiffs immediately, and to deal with subsequent forfeitures of rights to trust fund proceeds by allowing a loss deduction to a partner in the year of his forfeiture, and equivalent to the total tentative accruals forfeited. The remaining partners would then be taxed on the pro rata increases in their tentative accounts resulting from the liquidation of the forfeiting partner's account.[3]

The government and the plaintiffs have waged their battle on three separate legal fronts. For the reasons set out below, this Court finds that plaintiffs have prevailed in all three sectors.

I

One ground upon which the government seeks to uphold its action is by analogizing the facts here to those in *Lucas* v. *Earl*, 281 U.S. 111. In that case the Supreme Court refused to allow a husband to escape

[3] One of the plaintiffs here, Dr. Nadia Sorokowski, terminated her membership in the partnership in 1963, thereby forfeiting her rights to receive any payments from the trust. In 1966 the Commissioner on his own initiative, determined that Dr. Sorokowski was entitled to an ordinary loss deduction which would offset the assessment of trust income made against her, and the Commissioner made a further assessment against the remaining partners according to their pro rata tentative shares of Dr. Sorokowski's terminated account. Dr. Sorokowski has refused to accept the refund and stands with the other plaintiffs in contesting the Commissioner's deficiency assessments.

taxes on one-half of his income by having assigned one-half of it to his wife as a joint tenant. The Court declared that tax on a salary could not be avoided by the person earning the salary by anticipatory arrangements and contracts. The government here contends that it is the partnership which is earning the payments by Kaiser into the trust fund, and that, following *Lucas* v. *Earl*, the partnership (and hence the physician-partners *qua* partners) should not be allowed to escape immediate taxation through the assignment of the ultimate receipt of the payments to the partners *qua* individual trust fund participants. The government's contention has some persuasive force, but it ignores several lower court decisions which have persuasively refused to find *Lucas* v. *Earl* applicable in cases where a taxpayer confers the right to receive income upon another individual, but the taxpayer, while having earned the income, would never have had the right to himself receive it.[4] In

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[4] In *Commissioner* v. *Giannini*, 129 F. 2d 638 (9th Cir. 1942), the president of a bank refused without qualification his salary for the year 1927, offering a precatory suggestion that the money be used for some worthwhile purpose. The Commissioner argued, citing *Lucas* v. *Earl*, that "a taxpayer realizes 'income' when he directs the disposition thereof in a manner so that it reaches the objects of his bounty; * * *" 129 F. 2d at 640. The Ninth Circuit affirmed the decision of the Board of Tax Appeals that this money was not income to the taxpayer, because "the taxpayer did not receive the money, and * * * did not direct its disposition." 129 F. 2d at 641. In deciding the instant case, one cannot derive sufficient precedential force from *Giannini* alone, because Permanente *did* direct, as a co-party to the trust agreement, the disposition of the payments by Kaiser. Yet it should be noted that the present case calls more for a distinction from *Lucas* v. *Earl* than did *Giannini*, as regards the matter of initial right to receive the income involved. The taxpayer in *Giannini* had that right; Permanente never did.

Paul A. Teschner, 38 T.C. 1003, the taxpayer entered a contest in which the prize was an annuity policy to be used for college expenses. Only persons under seventeen were eligible to receive the prize, and any contest entrant over that age had to designate someone under seventeen to be the recipient. The taxpayer had designated his daughter as a recipient, and he won the contest. The Tax Court rebuffed the Commissioner's attempt to treat the prize as income of the taxpayer. In response to the Commissioner's assertion that "The basic rule in determining to whom an item of income is taxable is that income is taxable to the one who earns it * * *", the Court replied:

> If by this statement the [Commissioner] means that income is in all events includible in the gross income of whomsoever generates or creates the income by virtue of his own effort, the respondent is wrong. If this were the law, agents, conduits, fiduciaries, and others in a similar capacity would be personally taxable on the proceeds of their efforts. The charity fund-raiser would be taxable on sums contributed as the result of his efforts. The employee would be taxable on income generated for his employer by his efforts. Such results, completely at variance with every accepted concept of Federal income taxation, demonstrate the fallacy of the premise. 38 T.C. at 1007.

It must be noted that the Court reached its result despite the fact that the taxpayer's choice of a recipient relieved him of a later probable expense, that is, his daughter's college education. There is no evidence of such an effect in the present case.

Another case which is very much in point is *Nicholas A. Stavroudis*, 27 T.C. 583. The taxpayer was the beneficiary of a trust established in part with her own property and according to an agreement with the settlor. Under the terms of the trust, if the income from

the trust property exceeded an amount necessary to make the taxpayer's total income for that year equal to $25,000, then one-third of such excess was to be paid to the taxpayer, and the taxpayer had the power to appoint the remaining two-thirds to such of the settlor's children as the taxpayer chose. If the taxpayer failed to dispose of this two-thirds excess within 30 days after the close of the year, the undisposed portion would be added to the principal of the trust property. On these facts, the tax court held that the two-thirds excess income from a given year was not taxable to the taxpayer. This holding was made despite the court's acknowledgment of the fact that it was within the taxpayer's power, by a failure to appoint the two-thirds excess to any of the children, to increase the trust corpus and thereby derive a benefit to herself through her one-third interest in excess trust income. While the court in *Stavroudis* limited its discussion to the separate Code provisions and caselaw dealing with the tax treatment of trust income, a principle analogous to that in *Lucas* v. *Earl* also applies in this area and guides judicial decisions, see *Harrison* v. *Schaffner*, 312 U.S. 579, and *Stavroudis* is thus instructive in the disposition of the instant case.

This Court concludes, in the light of the above cases, that *Lucas* v. *Earl* does not require characterization of the payments to the trust fund as income of the partnership, with a resulting justification of the immediate taxation of the partners on their tentative shares of these payments. Instead, one can examine the nature of the payments vis-a-vis the partners, as if they had directly bargained with Kaiser for these payments. Viewed in this manner, the payments do not justify an immediate tax upon the partners, because the eventual enjoyment of these payments is

subject to the many contingencies established in the trust agreement. Arrangements similar to the Retirement Plan here have been held not to result in the realization of taxable income in the year in which employer contributions to a pension trust were made, where the employee taxpayer accounted for his income, as do the petitioners here, on a cash receipts basis. See *Julian Robertson*, 6 T.C. 1060, *acq.*, 1946 — 2 Cum. Bul. 4, and *Harold G. Perkins*, 8 T.C. 1051, *acq.*, 1947 — 2 Cum. Bul. 3.

Even if petitioners used the accrual method for computing their taxable income, immediate taxation would not be justified.[4] The regulations of the Internal Revenue Service provide: "Generally, under the accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Reg. 1.446-1(c)(ii). As to the effect of contingencies in computing the income of an accrual method taxpayer, Mertens states: "Income does not accrue to a taxpayer until there arises in him a fixed and unconditional right to receive the amount * * *. If there are substantial contingencies as to the taxpayer's right to receive or uncertainty as to the amount he is to receive, an item of income should not be accrued until the contingency or events have occurred and fixed the fact and amount of the sum involved. 2 Mertens, *Law of Federal Income Taxation* § 12.60, p. 209.

In *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, the Supreme Court rejected the notion that someone can be taxed on something which might never be received. In that case, the taxpayer was engaged

[4] "A fortiori, what is contingent income for an accrual basis taxpayer would also be contingent for taxpayers, such as the petitioners, who employ the cash method of tax accounting."

in litigation over the ownership of certain income-producing property, and the income from the property for 1916 was held by a court-appointed receiver pending the outcome of the litigation, and paid to the taxpayer in 1917. The taxpayer contended that the income was realized in 1916, and accordingly reported the income on its 1916 return. The government, however, contended that it was not realized until 1917, and the Court agreed:

> The net profits were not taxable to the company as income for 1916. For the company was not required in 1916 to report as income an amount which it might never receive [citations] * * *. [A]t no time during the year was there a right in the company to demand that the receiver pay over the money * * *. Nor is it material, for purposes of this case, whether the company's return was filed on the cash receipts and disbursements basis, or on the accrual basis. In neither event was it taxable in 1916 on income which it had not yet received and which it might never receive. 286 U.S. at 423.

In *Guarantee Title & Trust Co.* v. *C.I.R.*, 313 F. 2d 225 (9th Cir., 1963), the taxpayer corporation was in the business of servicing mortgage debts, and it had a contract with a bank whereby it got a fixed periodic payment from the bank for its services on mortgages, with a possibility of additional payments if certain contingencies occurred, such as prepayment of the loans. These additional payments would be made to the taxpayer according to a schedule, and were designed to compensate it in cases where premature satisfaction of a debt relieved the bank of the need for the taxpayer's services. The taxpayer, which kept its books on an accrual basis, established a bookkeeping account in which it accrued the pro rata amount of additional payments which it would receive as per the schedule if and when a given debt was satisfied

prematurely. The court held that the taxpayer needn't pay income tax on the amounts accrued in this account at the time of their accrual, because the eventual receipt of such amounts was too contingent. See also *Etheridge and Vanneman, Inc.* v. *C.I.R.*, 40 T.C. 461.

Long Poultry Farms v. *C.I.R.*, 249 F. 2d 726 (4th Cir. 1957), dealt with the taxability of a member of a tax-exempt agricultural cooperative on reserves held by the cooperative. A certificate was issued to the member in an amount representing his share of these reserves. The government contended that the amount represented by the certificate should be included in the member's proportionate share of the cooperative's income for tax purposes. While the specific sum represented by the certificate was credited to the member's tentative account, the cash redemption of the certificate was subject to several conditions, such as the making of a profit by the cooperative, and it could not be sold. The court held that the member, who was on an accrual accounting basis, could not be taxed on the amount represented by the certificate.

> To require the inclusion in income of contingent credits such as are here involved, would be to require the [members] of cooperatives to pay tax upon income which they have not received, over which they have been given no control and which they may never receive. Apart from the question of constitutionality of such a requirement, which would be a serious one, it is a safe assumption that Congress never intended to impose * * * the hardship and burden which the taxability of these contingent credits would involve. 249 F. 2d at 731.

II

Even if *Lucas* v. *Earl* were flatly applied here so that the payments by Health Plan into the trust were

regarded as being made to the partnership, a straightforward application of the long-standing principles regarding tax treatment of partnerships and partners would still require that we focus on the contingent nature of the rights which the individual partners have in the trust fund. The Code provisions dealing with partnership taxation call for application of what has come to be called the conduit approach. Section 702(b) provides:

> (b) Character of Items Constituting Distributive Share.—The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share [of partnership earnings] shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

In characterizing the nature of a partner's distributive share of partnership earnings under this approach, one must conceptually remove the partnership from the flow of the particular earnings, and imagine that a given partner as an individual will be the direct recipient of whatever earnings there are. From this viewpoint, one must ask what would be the taxable nature of the earnings in that partner's hands. See Senate Finance Committee Report, 3 U.S. Code Cong. & Admv. News, 83rd Cong., 2d Sess., p. 4722; 6 Mertens, *Law of Federal Income Taxation*, § 35.22, p. 63; and cf. Reg. 1.702–1(a)(8).

Applying the conduit approach to the present case, it is apparent that the cases dealing with the tax treatment of contingent earnings are once again applicable, and again the same result is reached with regard to the petitioners.[4]

[4] An interesting question arises, however, as to whether two of the cases cited above, *Perkins* and *Robertson*, would be relevant under this second analysis which flatly applies *Lucas* v. *Earl* and regards the partnership as being the "recipient" of the

III

The government has attempted to support its actions here by focusing on the trust arrangement involved. The government first argues that since Kaiser can never get back any of its contributions, the trust lies irrevocably in favor of Permanente and therefore Permanente through the partners should be immediately taxed on all accretions. The argument ignores the fact that the trust lies in favor of the *participants*, which includes mere employees of the partnership, and that it is possible under the terms of the trust agreement for all partner-participants to forfeit their rights in the trust and leave only the employees as beneficiaries.

The government also argues that Permanente is a co-grantor of the trust and that Permanente through its partners had the power to revest title to the trust in itself and distribute the proceeds, so that the government's action is justified under § 676 of the Code[1] and *Corliss* v. *Bowers*, 281 U.S. 376. But Permanente does not have this power. Under the trust agreement,

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payments. *Perkins* and *Robertson* involved taxpayers who used the cash method of accounting, and the courts in those cases deferred taxation on the basis of the constructive receipt doctrine. But when a partnership is present the rule is that a cash method partner must return his distributive share of income accruing to an accrual method partnership as that income accrues. *Appeal of Truman*, 3 B.T.A. 886 (1926), *Truman* v. *United States*, 4 F. Supp. 447 (N.D. Ill. 1933). The other contingent earnings cases discussed above involved accrual method taxpayers and would therefore be applicable even under the conduit analysis.

[1] SEC. 676. POWER TO REVOKE. (a) *General Rule.*—The grantor shall be treated as the owner of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both.

if a majority of the present number of partners (e.g. 110 out of 200) decided to terminate their contract with Kaiser and to discontinue serving Kaiser members, they would forfeit their rights in the retirement plan if 50% or more of the *participants* (e.g. the remaining 90 partners and the 40 employee-doctors) chose to continue serving Kaiser members. While the agreement provides that the partnership may replace the present trust with a trust having different terms, Permanente cannot do this without the joint agreement of Kaiser.

The government seeks to impute a termination power to Permanente because Permanente selects four out of the seven members of the Retirement Committee established in the trust agreement. But the Committee's power is limited to establishing and enforcing conditions which retired participants must satisfy in order to receive trust benefits, and also offering advice to the trustee on trust administration problems.

This Court thus concludes that the petitioners, and the other partners of Permanente, cannot be taxed now on the trust earnings attributed to their individual accounts, but that taxation must be postponed until the partner begins receiving benefits.

Accordingly judgment shall be for plaintiffs in each of the consolidated actions.

This opinion shall serve as findings of fact and conclusions of law in each of the consolidated actions under Rule 52(a). Plaintiff's counsel shall submit judgments in accordance with above memorandum opinion.

Dated: November 29 1968.

S/ ALBERT C. WOLLENBERG,
United States District Judge.

APPENDIX B

United States Court of Appeals for the Ninth Court

No. 24,170–75

September 16, 1971

JAMES A. BASYE AND EVELYN E. BASYE,
PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Appeal from the United States District Court for the Northern District of California

Before: MERRILL, DUNIWAY and HUFSTEDLER, *Circuit Judges.*

DUNIWAY, *Circuit Judge:*

Appellee taxpayers brought these consolidated actions in the District Court for the refund of income taxes paid for the taxable years 1960 through 1963. The District Court found in their favor, 295 F. Supp. 1289, and the government appeals. We affirm.

The case was submitted to the district court on the parties' agreed statement of facts. Taxpayers are physicians who, during each of the tax years involved, were general partners in the Permanente Medical Group (Permanente), a limited partnership organized in 1949 to practice medicine in California. The Articles of Partnership provide that "all earnings by any of the partners from the practice of medicine * * * shall belong to the partnership," and that each partner's "compensation shall be restricted to his distributive portion of the earnings of the partnership."

Permanente reported its income by the accrual method in the information returns that it filed for the years involved in these cases; appellees reported their individual income by the cash method.

Before the tax years in question, Permanente contracted with Kaiser Foundation Health Plan, Inc. (Kaiser) to provide medical services to members of Kaiser in its Northern California region. Kaiser operates a pre-paid hospital and medical care program for its dues paying members. The contract between Permanente and Kaiser provides for exclusivity of service—Kaiser agrees not to contract with other physicians for medical services and Permanente agrees not to render such services to other direct service, prepayment plans. Under the contract Kaiser pays Permanente as compensation for the services of its physicians a monthly sum based on the size of Kaiser's membership. In addition the contract contemplates the creation of a retirement plan to which Kaiser would make additional payments. Such a plan was established to take effect July 1, 1959, by a trust agreement between Kaiser, Permanente and Bank of America National Trust and Savings Association, as trustee. This retirement plan is the focal point of the tax controversy.

The primary purpose of the retirement plan is to insure Kaiser a stable and reliable pool of physicians providing medical service to its members. The plan accomplishes this purpose by creating an incentive for physicians to devote their careers to Kaiser members, either by remaining with Permanente or by joining some other group of physicians contracting to serve Kaiser members. The plan operates in the following manner. Kaiser makes payments into the trust each month as partial compensation for the services of Permanente. Any physician with a minimum of two years

service in Permanente, whether or not a partner, is eligible to participate in the plan. Each participant is assigned a certain number of "units" based on such factors as his salary, his past service with Permanente and his age at the time of his association with Permanente. The earnings of the trust fund (payments by Kaiser plus interest accrued on corpus) are tentatively credited to each participant's account in proportion to his assigned number of units.

When a participant retires, the total amount allocated to his account is used to purchase a retirement annuity contract. Until then, however, his account remains merely "tentative" because the amount allocated to it may change or his right to receive it at all may be defeated by the occurrence of one or more specified contingencies. First, if a participant in the plan leaves Permanente for reasons other than death or disability before either age 65 or the completion of fifteen years continuous service, and does not thereafter join another medical group serving Kaiser members, he forfeits all rights to the amount allocated to his tentative account. In the case of forfeiture, the amount forfeited is reallocated among the accounts of the remaining participants; none is ever repaid to Kaiser. Second, a participant will forfeit his right to the accrued benefits even after he has become eligible to receive them if he renders professional services for a competitor of Kaiser or if, while able to do so, he refuses to render consulting services to Kaiser or its affiliates. Third, if Permanente is dissolved or reorganized, and if at least 50% of the participants in the retirement plan reassociate with the reorganized Permanente or with another group serving Kaiser members, the trust fund remains intact and unretired participants who do not join the new group forfeit their accrued benefits. The forfeiture will not occur in two circumstances: (a) by mutual agreement Kaiser

and Permanente could use the trust funds to support a new retirement plan which would preserve the accruals of all participants; (b) in the case of dissolution or reorganization without the 50% regrouping, the trust fund is to be liquidated and the proceeds distributed *pro rata* to all participants.

During the four tax years involved Kaiser paid into the trust fund a total amount in excess of $2 million. Net earnings on the corpus amounted to an additional $60 thousand. Permanente did not report these amounts in its partnership income returns, nor did the partners include them in their individual returns. The Commissioner of Internal Revenue determined that the omission of these sums resulted in an understatement of partnership income and in deficiencies in the income tax returns of each of the partners. In computing the deficiencies, the Commissioner calculated the total amount of trust earnings attributable to employees' accounts in the retirement plan, and allocated this sum among the partners according to their distributive shares of partnership income. The theory of this assessment, apparently, is that the payments into the plan by Kaiser in favor of employees of Permanente relieved the partnership of an expense that it might otherwise have undertaken and thus created additional income. This part of the Commissioner's determination is not now contested. With regard to each partner's own tentative account in the retirement plan, the Commissioner treated the "unit" allocations as a modification of the distribution provisions in the partnership agreement and assessed each partner for the annual increment attributable to his own account. The latter assessment is the one in dispute here.[1]

[1] The district court's decision that the interest on the trust corpus is taxable to the trust is not contested on this appeal.

The taxpayers do not contend that the payments into the trust by Kaiser should never be taxed, but they do disagree with the Commissioner as to *when* the tax ought to be imposed and upon *whom*. Because of the substantial possibility of forfeiture of the right to receive the amounts allocated to the tentative accounts,[2] taxpayers argue, there is no current realization of income to the individual partners and taxation should be postponed until the right of receipt has become fixed. The government, on the other hand, prefers to tax now and to treat the amount on which the tax is paid as an addition to each partner's basis in his respective partnership share. Should a partner subsequently forfeit the amount in his tentative account, he would get a capital loss for that which was taxed earlier as ordinary income.[3]

This case thus presents the question whether the payments by Kaiser into the retirement trust were income realized by the taxpayers in the years in which the payments were made. We hold first that, viewing the taxpayers solely in their individual capacities as participants in the retirement plan, there is no current realization of taxable income. The amounts allocated to the tentative accounts are completely contingent and forfeitable; when payments are made to the trust, it is not possible to determine just who among the participants will ever receive the amount

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[2] During the years 1960–1963, twenty-three physicians forfeited tentative accounts totaling in excess of $60 thousand.

[3] In the trial court, the government took the position that a forfeiture gave rise to an ordinary loss deduction in the year of forfeiture equal to the entire amount of tentative accruals on which the tax had been paid in earlier years. Each remaining participant then had ordinary income in the amount his account was augmented by the forfeiture. Perhaps recognizing the bureaucratic nightmare thus created, the government has now changed its position.

in his tentative account or by how much his account will have been augmented by forfeitures of other participants at the time of receipt. Taxpayers have not constructively received the amounts allocated to their tentative accounts, because they have never had a right to immediate receipt of the payments and they have exercised no control over their disposition. The payments were made solely to fund the trust. Had a participant elected not to join the plan, he could not have received his allocable share as current income in lieu of payments into the trust. Finally, because the tentative accounts cannot be transferred or assigned and are completely forfeitable, the payments into the trust confer no immediate economic benefit upon the participants. *Cf. Commissioner* v. *LoBue*, 1956, 351 U.S. 243, 249.

For these reasons we conclude that had the taxpayers contracted individually with Kaiser for payments into a retirement trust subject to the same conditions involved here, they would not be subject to taxation in the years the payments were made. This conclusion accords with the decisions of both the courts and the Internal Revenue Service holding that payments made into deferred compensation plans which include substantial forfeiture provisions are not taxable until actually received or otherwise made available to the taxpayer, even though not qualifying for special treatment under §§ 401–404 of the Internal Revenue Code. See *Drysdale* v. *C.I.R.*, 6 Cir., 1960, 277 F.2d 413; *Schaefer* v. *Bowers*, 2 Cir., 1931, 50 F.2d 689; *Harold G. Perkins*, 1947, 8 T.C. 1051; *Julian Robertson*, 1946, 6 T.C. 1960; Rev. Rul. 67–449, 1967–2 Cum. Bull. 173.[4]

[4] Some of the authorities cited antedate the deferred compensation provisions of the 1954 Code. Nevertheless, the same realization rules apply to a post-1954, non-qualifying plan as apply to a pre-1954 plan.

The government does not contend that those cases were incorrectly decided but argues instead that because the taxpayers here chose to do business as partners rather than as individuals, the tax result is different. A partnership as such is not subject to the income tax. Int. Rev. Code of 1954, § 701. A partnership is required to report its income, however, and the partners are separately taxable upon their distributive share of partnership net income whether or not such share was actually distributed to them. Int. Rev. Code of 1954, § 702(a); Treas. Reg. § 1.702–1(a) (1956); *Heiner* v. *Mellon*, 1938, 304 U.S. 271, 281. The government argues that the payments into the retirement trust were undistributed partnership income and are thus taxable to each partner according to his proportionate share represented by his tentative account allocation.

The government's argument really involves two steps. First, the government argues, taxability of partnership income is to be determined at the partnership level (the "entity" approach). The taxpayers counter by arguing that taxability of partnership income is to be determined by ignoring the partnership and treating the individual partners as if they had engaged directly in the transaction in question (the "conduit" approach).[4] We assume, without deciding, that taxability is determined at the partnership level. But there

[4] The district court adopted the "conduit" approach. Because we hold that neither the partnership as an entity nor the partners as individuals realized taxable income, we find it unnecessary to choose between the "entity" and "conduit" approaches, and this opinion is not to be read as adopting either of them. For a discussion of the general problem of characterization of partnership income see Wolfman, *Level for Determining Character of Partnership Income—"Entity" v. "Conduit" Principle in Partnership Taxation*, 19 N.Y.U. Institute on Federal Taxation 287 (1961).

is a second step to the government's argument: the partnership has realized taxable income. We hold that in this case it has not.

Section 703(a) of the Code, in relevant part, provides that "[t]he taxable income of a partnership shall be computed in the same manner as in the case of an individual * * *." Thus we apply the same realization rules to the partnership that we would apply to an individual. During oral argument, government counsel, citing *Lucas* v. *Earl*, 1930, 281 U.S. 111, and *Hulbert* v. *C.I.R.*, 7 Cir., 1955, 227 F. 2d 399, relied principally upon a diversion of income theory. The Supreme Court in *Helvering* v. *Horst*, 1940, 311 U.S. 112, explained the diversion of income theory as follows:

> "[T]he rule that income is not taxable until realized has never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor. * * * The question * * * is, whether because one who in fact receives payment for services * * * is taxable only on his receipt of the payments, he can escape all tax by giving away his right to income in advance of payment. If the taxpayer procures payment directly to his creditors of the items of interest or earnings due him * * * or if he sets up a revocable trust with income payable to the objects of his bounty, * * * he does not escape taxation because he did not actually receive the money.
>
> "[I]ncome is 'realized' by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants." *Id.* at 116–17 (footnotes omitted).

In *Lucas, supra,* the taxpayer contracted with his wife to receive all earnings of either of them as joint tenants. The Court held that the taxpayer could be taxed on the whole of his salaries and fees earned by him during the tax years in question. *Hulbert, supra,* involved the sale of a partnership business with the provision that the sellers were to continue to operate the business until the date of consummation of the agreement and that one-half of the net profits during that period be paid directly to the buyer and the other half be retained by the sellers and applied against the purchase price. The court, holding the sellers liable for income tax on the entire amount of profits earned during the interim period, stated, "[t]he power to dispose of income is the equivalent of ownership of it and the exercise of the power to procure its payment to another is within the reach of the statute taxing income." *Hulbert* v. *C.I.R., supra,* at 401. The government argues that *Lucas* and *Hulbert* control this case because Permanente earned the trust payments as compensation for medical services, because the payments, from Kaiser's standpoint, were irrevocable and unconditional, and because Permanente, by contracting that the payments be made into the retirement plan, directed their disposition.

There is, however, a crucial element present in both *Lucas* and *Hulbert* that is missing here. Permanente never had the right itself to receive the payments made into the trust as current income. In *Lucas* the taxpayer had the right to receive his salary and fees and would have received them but for the anticipatory contract with his wife. Likewise, in *Hulbert,* the partnership, had it chosen not to enter the sale agreement or had it entered one under different terms as to the disposition of interim profits, would have received the whole of interim earnings as current income. In this

case the parties stipulated that "[t]he payments which [Kaiser] agreed to, and did make to the trust, were paid solely to fund the retirement plan, and were not otherwise available to [Permanente] or to the individual members or employees thereof." Furthermore, the Medical Service Agreement between Permanente and Kaiser provides that in the event Permanente establishes a retirement plan approved by Kaiser, Kaiser's contributions to the plan are to be *in addition* to all other sums payable by Kaiser. Thus, had Permanente elected not to establish the retirement plan, it could not have received additional current income. Nor is there any evidence in the record to suggest that Permanente agreed to accept less direct compensation from Kaiser in exchange for the retirement plan payments. That Kaiser would not have been willing to make the payments except into the trust under the conditions imposed is consistent with the primary purpose of the retirement plan: to insure Kaiser a stable and reliable group of physicians. The payments are to be viewed not as compensation for immediately past medical services but as compensation for the continued, long-term services of individual physicians. When the transaction is viewed in this light, the partnership becomes a mere agent contracting on behalf of its members for payments to the trust for their ultimate benefit, rather than a principal which itself realizes taxable income. We therefore conclude that Permanente, never having had the right to receive the income, could not have diverted it to others. Permanente's election to account for income on the accrual basis does not alter the result. A right that could never have attached could never have accrued. *Cf. North American Oil Consolidated* v. *Burnet*, 1932, 286 U.S. 417, 423.

The foregoing discussion of the government's diversion of income theory is based upon the assumption

that the government's "entity" theory as to the taxation of partnership income is correct, an assumption which we make but do not necessarily adopt. If on the other hand, the taxpayers' "conduit" theory were adopted, the same result would be reached. The individual partners did not divert income owing to them to the trust any more than the partnership did. Had there been such a diversion, it may well be that the members of the partnership would each be taxable on their share of the diverted income without regard as to whether the "entity" theory or the "conduit" theory is the correct one.

Because the taxpayers, whether viewed as individuals or as partners, realized no income in the years the payments were made to the trust, we affirm the district court's decision that they cannot now be taxed.

Affirmed.

United States Court of Appeals for the Ninth Circuit

No. 24,170–75

JAMES A. BASYE AND EVELYN E. BASYE, PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

ORDER

Before: MERRILL, DUNIWAY and HUFSTEDLER, *Circuit Judges.*

The opinion of this court, filed on September 16, 1971, as printed, is hereby modified in the following respects:

1. By striking out the sentence appearing in the last two lines of page 3 of the printed opinion reading

as follows: "This part of the Commissioner's determination is not now contested." [Page 34, herein.]

2. By striking out the sentence appearing at lines 4 and 5 of page 4 of the printed opinion reading as follows: "The latter assessment is the one in dispute here." [Page 34, herein.]

3. By placing after the word "account" in line 4 of page 4 of the printed opinion footnote reference 1. [Page 34, herein.]

The petition of appellees for a rehearing is denied.

APPENDIX C

United States Court of Appeals for the Ninth Circuit

No. 24170, D.C. #44352

JAMES A. BASYE AND EVELYN E. BASYE, PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Judgment

Appeal from the United States District Court for the Northern District of California.

This cause came on to be heard on the Transcript of the Record from the United States District Court for the Northern District of California and was duly submitted.

On consideration whereof, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this Cause be, and hereby is affirmed.

A true copy:

Attest: December 1, 1971.

WM. B. LUCK,
Clerk.

By EMIL E. MELFI,
Chief Deputy.

Filed and entered, September 16, 1971.

United States Court of Appeals for the Ninth Circuit

No. 24171, DC# 44353

JACK J. COOK & CAROL L. COOK, PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Judgment

Appeal from the United States District Court for the Northern District of California.

This cause came on to be heard on the Transcript of the Record from the United States District Court for the Northern District of California and was duly submitted.

On consideration whereof, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this Cause be, and hereby is affirmed.

A true copy.

Attest: December 1, 1971.

WM. B. LUCK,
Clerk.

By EMIL E. MELFI,
Chief Deputy.

Filed and entered, September 16, 1971.

United States Court of Appeals for the Ninth Circuit

No. 24172, DC# 44354

MAURICE C. FISHLER & PHYLLIS H. FISHLER,
PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Judgment

Appeal from the United States District Court for the Northern District of California.

This cause came on to be heard on the Transcript of the Record from the United States District Court for the Northern District of California and was duly submitted.

On consideration whereof, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this Cause be, and hereby is affirmed.

A true copy.

Attest: December 1, 1971.

WM. B. LUCK,
Clerk.

By EMIL E. MELFI,
Chief Deputy.

Filed and entered, September 16, 1971.

United States Court of Appeals for the Ninth Circuit

No. 24173, DC# 44355

HENRY DONALD GRANT & JEAN N. GRANT,
PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Judgment

Appeal from the United States District Court for the Northern District of California.

This cause came on to be heard on the Transcript of the Record from the United States District Court for the Northern District of California and was duly submitted.

On consideration whereof, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this Cause be, and hereby is affirmed.

A true copy.

Attest: December 1, 1971.

WM. B. LUCK,
Clerk.

By EMIL E. MELFI,
Chief Deputy.

Filed and entered, September 16, 1971.

United States Court of Appeals for the Ninth Circuit

No. 24174, DC# 44356

WILLIAM S. HUNTER AND JESSAMINE S. HUNTER,
PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Judgment

Appeal from the United States District Court for the Northern District of California.

This cause came on to be heard on the Transcript of the Record from the United States District Court for the Nothern District of California and was duly submitted.

On consideration whereof, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this Cause be, and hereby is affirmed.

A true copy.

Attest: December 1, 1971.

WM. B. LUCK,
Clerk.

By EMIL E. MELFI,
Chief Deputy.

Filed and entered, September 16, 1971.

United States Court of Appeals for the Ninth Circuit

No. 24175, DC #45575

GEORGE W. SOROKOWSKI AND NADIA SOROKOWSKI,
PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Judgment

Appeal from the United States District Court for the Northern District of California.

This cause came on to be heard on the Transcript of the Record from the United States District Court for the Northern District of California and was duly submitted.

On consideration whereof, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this Cause be, and hereby is affirmed.

A true copy.

Attest: December 1, 1971.

WM. B. LUCK,
Clerk.

By EMIL E. MELFI,
Chief Deputy.

Filed and entered, September 16, 1971.

APPENDIX D

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

* * * * *

(13) Distributive share of partnership gross income;

* * * * *

SEC. 401. QUALIFIED PENSION, PROFIT-SHARING, AND STOCK BONUS PLANS.

(a) *Requirements for Qualification.*—A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section—

(1) if contributions are made to the trust by such employer, or employees, or both, or by another employer who is entitled to deduct his contributions under section 404(a)(3)(B) (relating to deduction for contributions to profit-sharing and stock bonus plans), for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan;

(2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part

of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries;

* * * * *

(4) if the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees.

* * * * *

SEC. 404. DEDUCTION FOR CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN.

(a) [as amended by Sec. 24, Technical Amendments Act of 1958, P.L. 85–866, 72 Stat. 1606] *General Rule.*—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but, if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

* * * * *

(5) *Other plans.*—In the taxable year when paid, if the plan is not one included in paragraph (1), (2), or (3), if the employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid.

* * * * *

SEC. 701. PARTNERS, NOT PARTNERSHIP, SUBJECT TO TAX.

A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

SEC. 702. INCOME AND CREDITS OF PARTNER.

(a) *General Rule.*—In determining his income tax, each partner shall take into account separately his distributive share of the partnership's—

* * * * *

(9) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

* * * * *

SEC. 703. PARTNERSHIP COMPUTATIONS.

(a) *Income and Deductions.*—The taxable income of a partnership shall be computed in the same manner as in the case of an individual except that—

(1) the items described in section 702(a) shall be separately stated, and

* * * * *

SEC. 704. PARTNER'S DISTRIBUTIVE SHARE.

(a) *Effect of Partnership Agreement.*—A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

* * * * *

U.S. GOVERNMENT PRINTING OFFICE: 1972